DOW THEORY LETTERS INC.

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36 Letters per Year — $125 Annually

Registered with the Securities Exchange Commission

June 30, 1976 Letter 668

June 18, DJIA 1001.88; PTI 597; A-D ratio -23.35
June 25, DJIA 999.84; PTI 604; A-D ratio -23.18

THE MARKET: The market is moving into an increasingly significant position from the technical standpoint. So far in this second psychological phase, we know that the public has remained bearish. The latest statistics shows that in May the mutual fund public sold a whopping $348 million (in funds) more than they bought. On top of this, the odd-lot public continued to crowd the exits at a rate of about 240 on the odd-lot ratio, which means that they sold about 240 shares for every 100 shares they purchased.

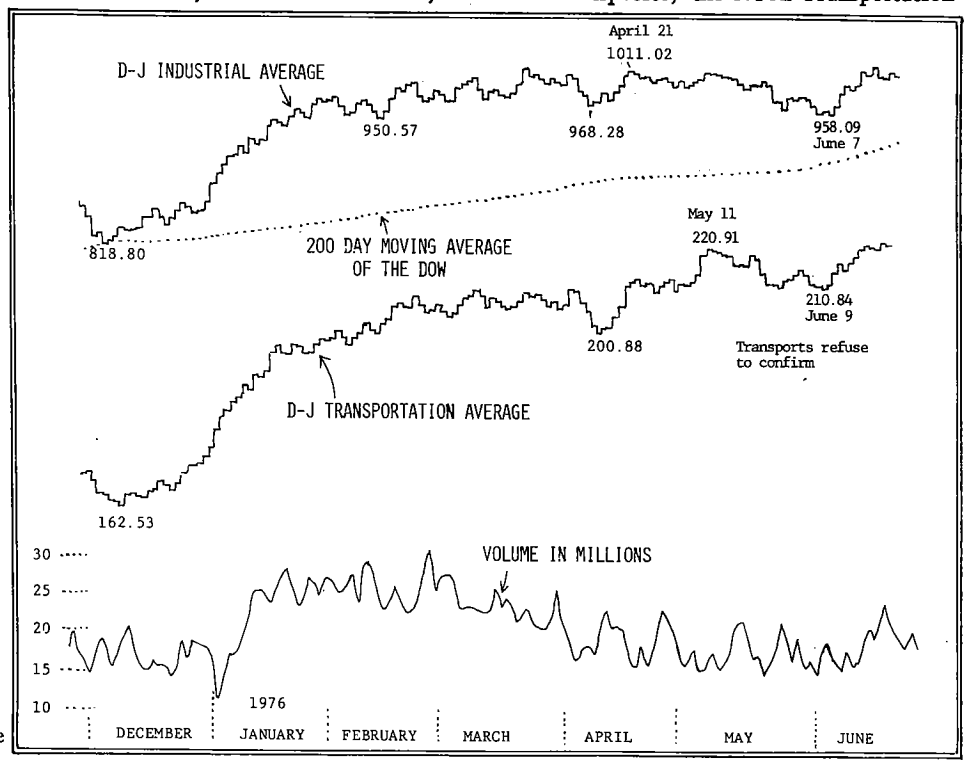
I want to remind subscribers that the second phase of a bull market usually moves on public skepticism, rather than public participation. This "I just don't believe it" attitude can last the entire length of the second phase. When the ultimate correction of this second phase arrives, I would expect public sentiment to turn black. That should lay the groundwork for the final third phase of the bull market (the phase where the public decides that it wants in—usually with both feet). But in order for the third phase to develop, the market must be literally "out of stock," clean, on the sidelines.

Why has the public stayed so bearish during 1976? Probably because they are still thinking in terms of the 1966 to 1974 bear market, and more specifically in terms of the 1973-74 wipe-out. It takes two or three years (or even more) for the public to really reverse their stance on the market, and obviously today's public is not ready to believe that this market can go higher. But someone seems to believe in higher prices, because someone has been taking in all the stock that Charlie Johnson and Roy Fuddy and Marylou Cashlow are selling. That "someone" would appear to be investment money, smart money, institutional money.

And how about the fascinating technical situation which I mentioned? Well, here's the way I see it. The primary trend is bullish, and that means that we will give the benefit of the doubt (during any and all periods of uncertainty) to the bulls. We've had a period of uncertainty for the past four months, or ever since the D-J Utility Averaged topped out at 91.90 on February 4. A few weeks later (on February 24), the Advance-Decline ratio topped out. Next, the various Averages peaked out, together with most of the technical indicators.

But in general, the Averages have given a fairly good account of themselves. So have a number of the indicators, and this constructive action has kept me bullish (even on the secondary trend) throughout 1976. In this report I want to present both sides of the picture, the bullish side and the potentially bearish side (and when I say bearish, I mean bearish only in a secondary sense).

On June 21 the market made quite an upside showing. On that day, the D-J Transportation Average hit a new high, although that high was not confirmed by the D-J Industrial Average. Nevertheless, the following Averages and indicators also hit new bull market highs on June 21: the Standard & Poor's 500 Stock Index, the S & P Industrials, the NYSE Composite, the NYSE Transportation Average, the Cumulative Most Active Stock Index and my own Primary Trend Index. That was an excellent showing.



Following the June 21 "explosion," the market backed off a bit, then started up again. From the bullish standpoint, I would now like to see the D-J Industrials push above their 1011.02 (April 21) high for the year, confirmed by successive new highs in the Transportation Average. Such action (particularly on rising volume) would bode well for the bulls.

I have been watching the D-J Utility Average with interest. This Average hit a little peak of 87.62 on April 5, declined and then touched a peak of 87.87 on April 26, dipped, and then hit a peak of 87.87 again on May 7. On May 29 Utilities sank to a low of 84.52. Since the Utility Average is money rate-oriented, and since this Average often leads the other Averages, I would like to see Utilities (1) continue to hold above

 84.52, and even better (2) move above the 87.87 level. If Utilities rallied above 87.87, I would take this as an extremely bullish sign for the rest of the market.

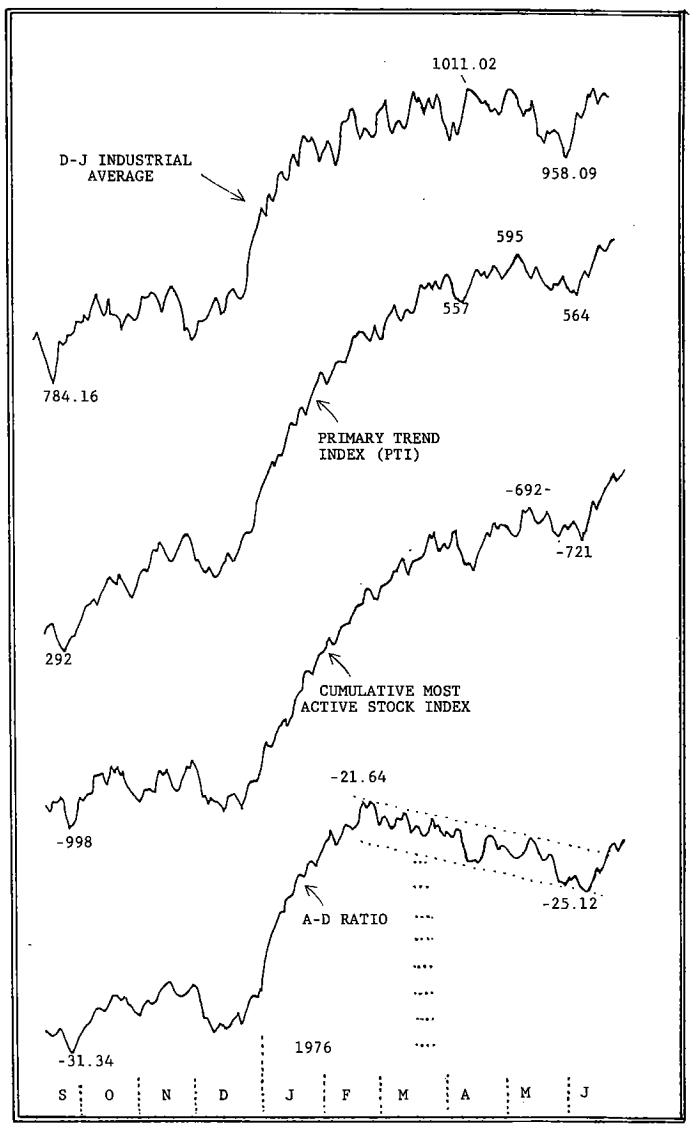
So from the bullish standpoint, that's it. The D-J Transports are doing their part in recording new bull market highs (the latest being on May 25). The Industrials are still lagging, but I am certainly willing to give them the benefit of the doubt and say that they "look like they want to move up and better the 1011.02 peak." The Utilities are finally starting to come to life, moving up with increasing emphasis (and that's a big plus for the market). Confirming the Utility move, the D-J 40-Bond Average is also rallying, having pushed impressively off its early June low.

The various other Averages (the NYSE spectrum and the S&P series, as previously mentioned) look good. The Primary Trend Index (see chart) hit a new bull market high on June 25, the CMAS is very near a new 1976 high, and my "tick index" which I will go into in a forthcoming report is looking stronger than at any time since December-January.

Conclusion: The primary trend is bullish and has been since December, 1974. The secondary is bullish, and I will regard it as remaining bullish as long as the D-J Industrials and Transports hold above 958.09 and 200.88 respectively (see page 1 chart).

MY WORRY: My main worry here has to do with the lagging advance-decline ratio (see chart). Here again, I am giving the bull market the benefit of the doubt. I think (and hope) the A-D will confirm by moving up above its February 24 peak. If it can do that, we could be in for a major and perhaps extraordinary bull swing. But if the A-D ratio only pushes up in direction while refusing to better its February 24 peak, then I would be much less impressed with the market potential over the remainder of 1976. In other words, it is action of the A-D ratio over the period ahead which will probably tip the market's hand! I can not stress this strongly enough. In order to emphasize how closely I am watching the A-D ratio, I am presenting this detailed section of the Letter as follows.

BREADTH-PRICE RELATIONSHIP: As readers who own my Advance-Decline ratio chart book know, the relationship between the Dow Industrials and the A-D ratio is a critical one. I have studied this relationship for over twenty years, both with the help of James Hughes, who (along with Colonel Ayres) invented the A-D ratio, and on my own. Any careful study of the breadth-price relationship will show that these two indicators tend to move in harmony with each other. Where they diverge, where they refuse to confirm each other, we have a period of disharmony. In the great majority of cases, a period of persistent disharmony between the Dow and the A-D will result in a correction. That correction will usually erase the movement which created the disharmony.



It was Hughes who first called my attention to the fact that extended periods in which the Dow makes new highs, unconfirmed by new highs in the A-D ratio, lead to trouble. This is not always true, but it is true in the great majority of cases.

I want to go over some of the outstanding modern instances now, because I want readers of these reports to understand this principle thoroughly. In 1947 the Dow and the A-D hit peaks together in February. The Dow then went on to record new highs into July of that year, peaks unconfirmed by the A-D ratio. The lag amounted to five months. This period of solo Dow highs was followed by a major decline into February, 1948.

In 1957 the two indicators hit highs in January. Industrials then went on alone to record a new peak in July, seven months later. This long non-confirmation period was followed by a market smash into October, 1957.

In 1959 the two indicators hit peaks in March, but the Dow went on to record solo peaks into January, 1960, ten months later. This was followed by a severe decline into October, 1960.

In 1961 the two indicators hit highs in April, followed by new unconfirmed Dow highs in December, seven months later. The crushing 1962 smash followed.

The 1963 episode provided a great exception. The two indicators hit highs in May. The Dow then went on to record further unconfirmed highs during 1963 and 1964. Finally, in October of 1964

the A-D pushed ahead and confirmed the Dow. The long A-D period of non-confirmation never set off a market slide. And confirmation finally did occur.

In 1965, highs in the two indicators were recorded in May. But the Dow went on to touch a new unconfirmed high in February, 1966, nine months later. That action ended the great bull market of 1949-66.

In 1972 the two indicators set highs in March. But Industrials went on to set new unconfirmed highs into January, 1973, ten months after the A-D peak. The result was the worst smash since 1929-32.

So much for the past history of some of the important and extended periods in which the A-D ratio refused to confirm new highs recorded by the Dow. One of the things which I am now watching, and one of the things that is bothering me is the current period of A-D nonconfirmation. I will outline the current situation again (please refer to the chart). The Dow and the A-D recorded joint highs on February 24. A slide ensued, followed by new unconfirmed highs on the Dow. The last Dow peak occurred on April 21 at 1011.02. If the Dow was to push up and hit a new closing high this week, it is clear (as you study the chart) that the A-D would probably not confirm. This would mean a new high in the Dow four months after the last confirmed joint highs in the two indicators.

Now I'm not saying that the A-D won't act the way it did in 1963, I'm not saying that the A-D won't turn up and push above its February 24 high. But I am saying that the A-D is still lagging, and that it still has about 2 points to go to better its February peak.

The stock market is a perverse devil, and it has its own way of doing things. Somehow, I feel that the Dow Industrials "mean" to run up and above their April 21 high of 1011.02. But I'm going to watch very carefully, if that happens. Because I want to note the manner in which that happens (if, indeed, it does happen). I want to see whether Transports confirm by making new highs, I want to see whether volume expands, I want to see whether there is broad participation.

But most of all, I want to see whether the A-D ratio really moves up with the Dow as if it means to push through its February 24 peak. Because if the A-D ratio continues to lag, particularly on a new Dow high, I am going to advise real caution, scaling back, a position of defensiveness. I base this statement on the six out of seven aforementioned instances in which the A-D lagged for extended periods of time following new highs in the Dow.

Question: Russell, does this mean you're changing your mind about this being a primary bull market? Answer: No, it does not. But it means that I'm doing my duty by pointing out a potential danger signal. A big spurt in the Dow here unconfirmed by very good action in the A-D ratio could mean that the market is building up to a big correction, the correction that would probably end the second phase of the bull market.

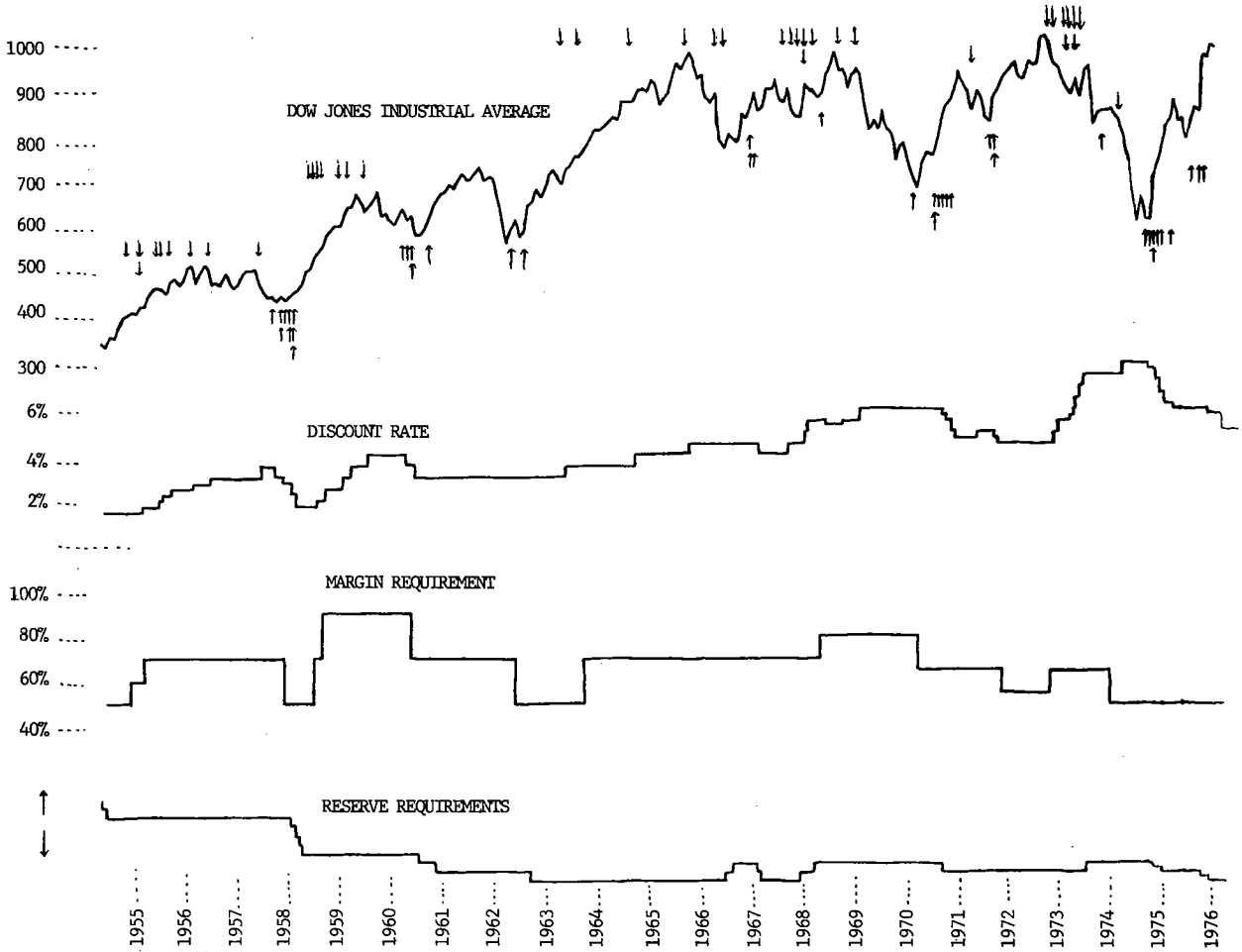
Question: But suppose we are in another 1963? Suppose the Dow goes to a new high, and the A-D pushes up and confirms? How do you know that won't happen? Answer: Look, I'm reasonably intelligent, I think, eat, sleep and dream about the stock market, but I'm not a prophet. I hope that the A-D ratio will push up in direction and confirm a new high in the Dow. And I rather think it will. But my job is to tell subscribers what I think and what I know and what I am watching for. And I am watching the breadth-price relationship right now. And that's what I want you to watch. And I want you to be prepared to be very defensive in case the Dow pops up through 1011.02 while the breadth of the market turns sloppy or fails to rally.

Question: How about all your other indicators? How about the Transports, the PTI, CMAS, etc? Don't they all look OK? Answer: The Transports look great; they've been hitting new highs, the latest being the 221.62 high of June 21. The PTI and CMAS (see chart) have also been pushing to new highs, and they have been a major factor in my continuing bullishness. But I still want to see the breadth-price relationship straighten itself out on the upside. I've been in the market too long to ignore the critical relationship between the Dow and the A-D ratio. What more can I say?

Question: Russell, how far could the Dow go on the upside without an A-D confirmation (i.e., a new A-D high?). Answer: You could conceivably get one hell of a spurt on the Dow, don't think you couldn't. That's actually what happened in most of the past instances (1957, 1959, 1961, 1965, 1972). But that final push amounted to the last uphill run prior to a drastic decline. And that's what I want to get across to subscribers. If the Dow takes off on a solo flight from here, without real confirming A-D strength, then let's be careful. We'd probably be witnessing a bull trap, and one I would want my subscribers to lighten up on, sell into (but certainly not to buy into).

THE FED: Attention to money rates and what the Federal Reserve Board is going to do has reached almost hysterical proportions of late. There is no doubt about it, what the Fed does will almost surely affect the market in due time. In other words, the Fed is a force to be reckoned with. Nevertheless, the market does not automatically jump to the Fed's tune. The Fed cannot make a bull or a bear market. What the Fed can do is influence the investment climate during a bull or bear market.

It is my opinion that every bull or bear movement possesses a certain definite "potential." When a bull swing starts at say 850 on the Dow, that movement may have an ultimate bullish potential of say 1100. How or when the Dow gets to 1100 may be influenced greatly by Fed action, but the Fed is not going to stop the Dow from ultimately going to 1100. True, the Fed may prevent the Dow from going to 1100 this month or even this year, but before the primary bull market is over the Dow is going to fulfill that bullish potential. It's going to get to 1100 come hell or high water.



The Fed has three basic "tools" which it utilizes to accelerate or halt the stock market's progress. The three tools have to do with credit. They are the bank discount rate, the reserve requirements of the banks and the margin requirements for buying stocks. The use of one, two or all three of these tools affects credit, investor psychology and the market itself.

Mr. Ned Davis of JC Bradford Co., Nashville, TN, has run a chart of the Dow and the three Fed policy tools all the way back to 1933. I have included the chart for the period of 1955 to date, and I think that 31 years of Fed action should suffice to illustrate how the whole syndrome works (see chart above).

As a rule, it takes three or four moves by the Fed via their policy tools (or a combination of two or three of them) to affect the market in an important way. Nevertheless, the timing is never exact. For instance, note how persistently the Fed "fought" the rise during 1955-57 before the market turned down. Note again during 1959 and then in 1968-69 how persistently the Fed positioned itself against the market before the Dow turned down.

Market bottoms usually form much more rapidly than market tops, and often the market will hit bottom (the bearish potential having been reached!) before the Fed even begins to loosen up credit. Thus, what actually happens is that the market heads up, and then the upward progress is spurred by the Fed's easing up on the credit reins.

The Fed watchers might as well face the fact that they have not discovered the perfect way of beating the market. The example of 1962 proved the point. The market collapsed during '62 in a move brought on by President Kennedy's frightening confrontation with the steel companies. Nothing in Fed policy or bank credit statistics indicated that the big stock market slide was coming, and this action should serve as a warning to those who think the market's hand is always tipped by the Fed. It just ain't so.

Most recently, the Fed eased up in ten instances (following the 1974 bottom), as you can see by the up-arrows on the chart. Just as important is the fact that since the 1974 lows, there has not been a single down arrow. The conclusion is clear: the Fed is not trying to put the brakes on the economy or the stock market at this time. The fact that 1976 is an election year may be influencing the Fed, in that that agency probably would not want to hurt the stock market during an election period. But for our purposes we only have to know one thing. We know that the Fed is still saying "Go" to Wall Street!

THOUGHTS: Many readers may wonder why I am so agitated by Federal spending and debt. All right, ponder this: It took almost two centuries (actually 186 years) for U S Federal spending to hit $100 billion. That milestone event was reached in 1962. Within 9 years Federal spending had climbed to $200 billion in fiscal 1971. Only 4 years later, in fiscal 1975, Federal spending soared to

$300 billion. And based on what we know now, fiscal 1977 (two years later) will produce Federal spending of over $400 billion. All this has served to run the total Federal deficit through the roof. That deficit will exceed $720 billion by fiscal 1977. Something will have to give, and it will be either prosperity, the currency, the economic system or the very structure of the nation. No country in world history has ever survived this kind of fiscal irresponsibility! (Figures courtesy of Money & Credit, 919 Third Ave., NYC 10022).

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Here's a thought which I read recently and can't resist quoting: "There is a principle which is a bar against all information, which is proof against all argument, and which cannot fail but to keep a man in everlasting ignorance. That principle is condemnation before investigation." (Spencer).

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The U S (and every other) mail system is the bane of my life. Every day or so I get a letter from an anguished subscriber here or in some other part of the world complaining about delivery of Dow Theory Letters. We do our darnedest, Letters are rushed to the Post Office as soon as they are collated, and this is the best we can do on this end.

Sometimes I think we should put together a book of complaints and send them to the Postmaster (or maybe to Simon & Schuster). For instance, this one came in last week: "Could you please send us another copy of the latest Letter. The first one was partially incinerated in a plane crash in Cheyenne." (From BM, Moose, Wyoming). Here's another: "Just wanted you to know that it took 6 days for your Letter to arrive at my residence. From June 9 to June 14, it seems to me I should have gotten it by the 11th. What do you think?" (from SM, Pittsburgh, PA). What do I think? I think he's right.

Finally, this letter was just received from RMQ, an American subscriber who is teaching in Mexico this summer: "Please use airmail on my address change. Regular mail is floated in a bottle to Puerto Vallarta and then taken by burro over the Sierras to Guadalajara. If Mexico (or any Spanish-speaking country) ever grows up, I'll be distinctly surprised." Yes fellow sufferers, there are systems in the world even worse than the US mail system!

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Do you fancy yourself a smart gambler? Want to "beat 'em" at Vegas? Then think about this, from the latest MGM report. The MGM Grand Hotel in Las Vegas (fiscal year ending Aug. 31) reports that the Grand took in $80.7 million net at its gambling operations. To bring the people in, MGM actually gave away $18.9 million in luxury hotel services, rooms, food, drinks, entertainment, etc. Now MGM is planning to build another Grand Hotel, in Reno — and who can blame them. My conclusion: eating, sleeping and having fun at the MGM Grand in Vegas is a bargain. Gambling at the Grand in Vegas it a bargain for MGM.

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People keep asking me what I think of Jimmy Carter, who appears to be next in line for the Presidency. Someone called Carter a "southern fried Humphrey," and I guess that's pretty harsh. But look at the record. Carter wants to Federalize welfare, and he wants national health insurance. He's for the Humphrey-Hawkins full employment bill, and he espouses a guaranteed annual income. He would like to transfer an additional $20 billion per year into the education industry. They're all noble thoughts, but I'm not sure we can afford a single one of them. Not sure, well the fact is I'm damn sure we can't afford any of them. So Carter is really a kind of God fearing member of the Great Society crowd. But I'm willing to revise my opinion if Carter turns out to be both God fearing and proficient at math.

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Mr. S.J. Levy (Box 26, Chappaqua, NY 10514) has a record of economic forecasts second to none. He's really been "right on" when it comes to using his extraordinary economic crystal ball. In his latest report, S.J. states that things are going to be good. The second half of '76 is to be better than the first. "Improvements in productivity will restrain industrial prices....Business expansion, spurred by a strong climb of corporate profits, will extend the trends of production, employment, and sales beyond mid-1976." Later, S.J. predicts, that corporate profits (after being up 50% in the first quarter of '76 over first quarter '75) "will advance at least 25% during the 12 months ending with the first quarter of 1977." I wouldn't argue with S.J.; he has a habit of being right.

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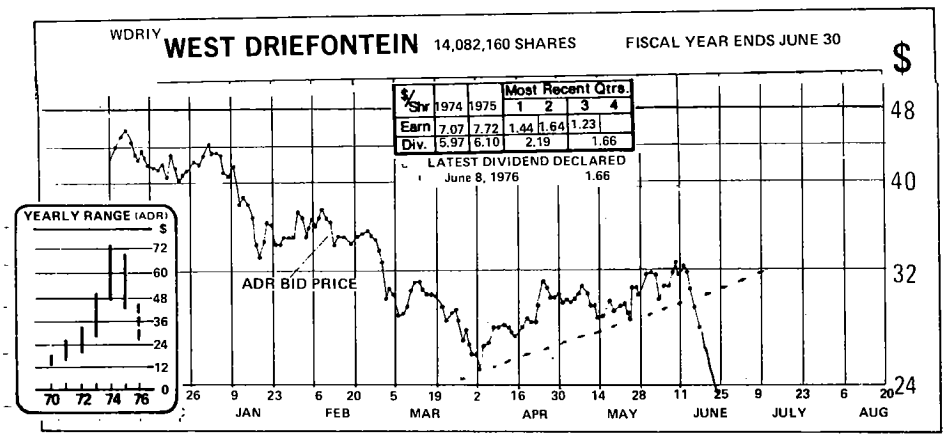
Following my castigation of NYC in Letter 664, I got a letter (still vibrating with anger) from none other than my brother-in-law, president of a film company (he lives in the beloved City). All right, Lee Bobker, have your say, and I'm sure it will make all my New York subscribers feel better: "You criticize the hotel but who told you to say there - I agree with you - any Sheraton is a catastrophe! You knock the prices at 'a typical New York deli' but let me tell you I would rather pay anything for a corned beef sandwich at the Stage than eat what passes for corned beef on the West Coast (I just came back from two weeks in Los Angeles and San Francisco). You say 'the NYC atmosphere rots mens' souls.' But I say it is the vitality, the round-the-clock excitement, and the ability to be oneself and live on one's own terms that has made my entire way of life possible.

"The only interesting people I meet are the people who live in the great cities of the world. Next time stay at the Regency or the Carlyle. Eat at Lutece or Grenouille or any one of a thousand other truly great restaurants... choose from a dozen superb movies or just walk through the streets to learn what it is to be alive...only in London, Paris, Hong Kong, etc. can one live totally and fully....anyway the debate goes on."

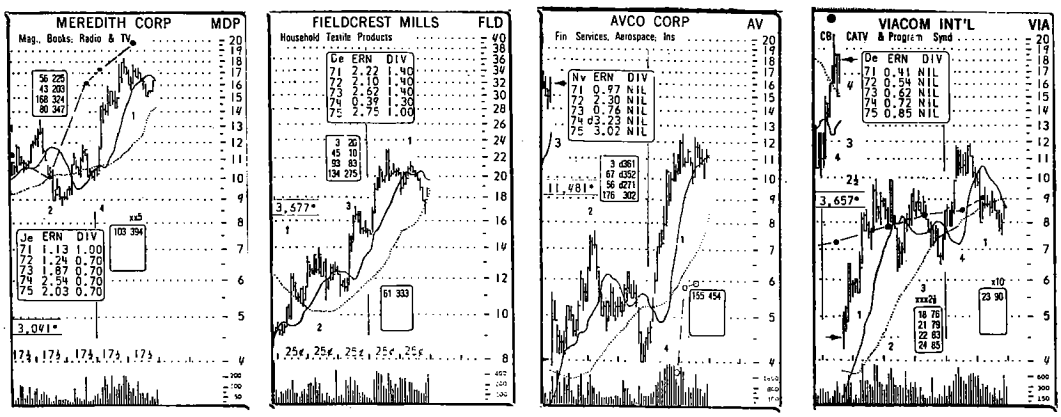
GOLD-SILVER: As of the new week (starting June 28) gold finally sagged below the 124-5 support to an afternoon London fixing of 123.90. Silver, probably in sympathy with gold, fell back within its giant triangle, back to the 4.70 level. For those with a limited percentage (5% to 10%) of assets in gold or gold coins, the new slide means little or nothing. I recommended gold as insurance against disaster, and just as the man with a life insurance policy doesn't bemoan his bad luck because he hasn't died yet, the man with a "survival position" in gold should not knash his teeth because the world has so far failed to go up in inflationary flames.



This daily chart (courtesy of South African Gold Service, Palisades Pk, NJ 07650) says it all. Here is West Driefontein, one of the great gold mining giants, bumping around the 24 area, an area almost 70% under its 1974 bull market high (see annual range on the chart). The little April-June rising trendline could not stand, and the best holders can hope for now is a "double bottom" in the 24-25 area.

With the black-white racial problems now flaring into open violence, with the rest of Africa on the verge of supporting black revolution in S. Africa, the SA gold shares are obviously all speculations, but this should not come as news to my readers. Gold above ground is now worth more than gold in the ground, and when I say "above ground" I might as well add, in your vault. What do I think of the future of gold? Just what I've always thought. Gold will be used for money long after every single paper currency in current use has been relegated to the category of a museum or a collector's item. It's simply a matter of timing.

STOCKS: The Ranchers Expl. and New Mexico-Arizona Land recommended in the last reports have "taken off like birds." There's not much speculation in this market, but the uranium bug seems to be catching on. Count on one thing—the market will overdo the uranium concept as it does everything else. In the meantime, holders of RAN, NZ and FN will have fun.



As I go through the list, I'm amazed by the number of real values around. I include charts (courtesy of Quote, PO Box 213, Wichita, KA 67201) of four stocks which I feel represent value, all of them in Value Line's list of issues expected to perform best during the year ahead. Let your broker do some work on these shares. Note the low P/E ratios on all but Viacom, which has enough glamour to make up for its lower P/E ratio.

One group mentioned earlier in this report which is showing increasing signs of life is the Utilities. Many of the utility shares are still yielding around 9%. Eliot Janeway expects the Utilities "to pull another surprise and emerge as the leaders of a Carter bull market." He could well be right. Also, check the option prices on such utilities as Amer. Electric Power and Virginia Electric. AEP has an option for Feb. 1977 at a 25 striking price. The option sells for 3/8's. That means that for around $400 you can buy an option on 1,000 shares. VEL has a 4/16 option for Jan. '77, at a striking price of 15. That's big leverage for little money. When you get options that "cheap" in a group that's out of favor, it's always an interesting play for speculators. For instance, if AEP goes to 28 by February of '77 you'd make around $3,000 on $400. The risk reward is extremely attractive.

LATE NOTES: The Wilshire "All Stock" Index hit a new bull market high of $876.2 billion this week. I'd call that bullish. My most recent tabulation of weekly new highs (over the last 52 weeks) as a percentage of all common stocks traded (NYSE) just hit 9.2%, highest since the 9.3% of late-March. That's impressive. Watch two figures carefully, the NYSE Financial Average bull market high of 54.31 and the recent triple peak in the D-J Utility Average of 87.87. If the two Averages better those highs, I feel it will be a real spur to the market. The NYSE Fin. contains over 200 finance-oriented issues, while the Utility Av. tends to be a good leader. .....This market looks increasingly strong. The A-D is trying to catch up with the Dow. The big problems for Dow are still its steep rate of advance since late-1974, and the very large Dow-bond yield spread in favor of hi-grade bonds—4.69%. There have been 13 boosts in assorted Dow Industrial dividends in this bull market so far, and of course, that kind of action helps the bond-stock yield spread.

On a relative strength basis, a computer run by S.H. Dike Co., 1420 Carlisle Blvd. NE, Albuquerque NM 87110, shows the top 5 DJIA stocks to be Alcoa, XON, United Technologies, St. of Calif., Inter. Harvester — all resources or capital goods. Bottom 5 are Esmark, Allied Chem., Woolworth, Kodak, Sears—all but ACD being consumer oriented. But I prefer not to trade around in a bull market; ultimately they all move up. Next mailing: July 9th